

the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

240. In fact, Dell did not adequately accrue warranty liabilities, specifically for its OptiPlex™ products, which later led to a \$307 million charge to account for significant unaccrued for liabilities for this product.

OptiPlex™ Products

241. Dell's warranty obligations during the Class Period for the OptiPlex™ products were a significant issue. For business systems, including OptiPlex™, Dell offered a standard three-year warranty with on-site service, increasing the likelihood it would incur significant costs. The OptiPlex GX270 systems in question (both the GX270 and GX280 desktops were later disclosed to have the problem with the motherboard) were introduced in 5/03, with Dell representing that the systems, which came with "a three-year next-business-day onsite service," are

designed for networked business environments, with long product lifecycles, standards-based technology and a full suite of user-friendly management tools, making them easy to deploy and maintain.

242. In the same press release on 5/21/03, Dell said the following about the systems:

Also new to the OptiPlex line is the availability of Serial ATA disk drives, which offer faster data transfer rates than Parallel ATA drives and employ smaller cables, improving airflow within the chassis.

"These two new systems provide more balance between performance and being able to set more aggressive goals for reductions in power consumption," said Tim Mattox, vice president of Client Product Marketing for Dell. "These two products offer stability, strong management features and outstanding price/performance for enterprise customers."

The GX270 and SX270 qualified for the ENERGY STAR(R) designation due in large part to its support of S3 "sleep state," which suspends a user's session to RAM after a preset time and consumes less than 15 watts of power while activated. When these systems are S3-enabled, they can help customers reduce energy costs by up to \$175 per system over 3 years when compared to the same systems operated in screen saver mode. If all of Dell's U.S. GX270 and SX270 customers operated in S3 mode for one year, enough energy could be saved to power an estimated 90,000 homes.

243. The combination of Dell's representations about the stability and performance of the OptiPlex products with its three-year standard warranty increased the likelihood that if there were any problems at all with the systems that customers would be both disappointed with the product and both likely and entitled to require Dell to fix the problems.

244. GAAP, as set forth in SFAS No. 5, ¶¶24-25, states the following with respect to warranties:

24. A warranty is an obligation incurred in connection with the sale of goods or services that may require further performance by the seller after the sale has taken place. . . . Losses from warranty obligations shall be accrued when the conditions in paragraph 8 are met. Those conditions may be considered in relation to individual sales with warranties or in relation to groups of similar types of sales made with warranties. If the conditions are met, accrual shall be made even though the particular parties that will make claims under warranties may not be identifiable.

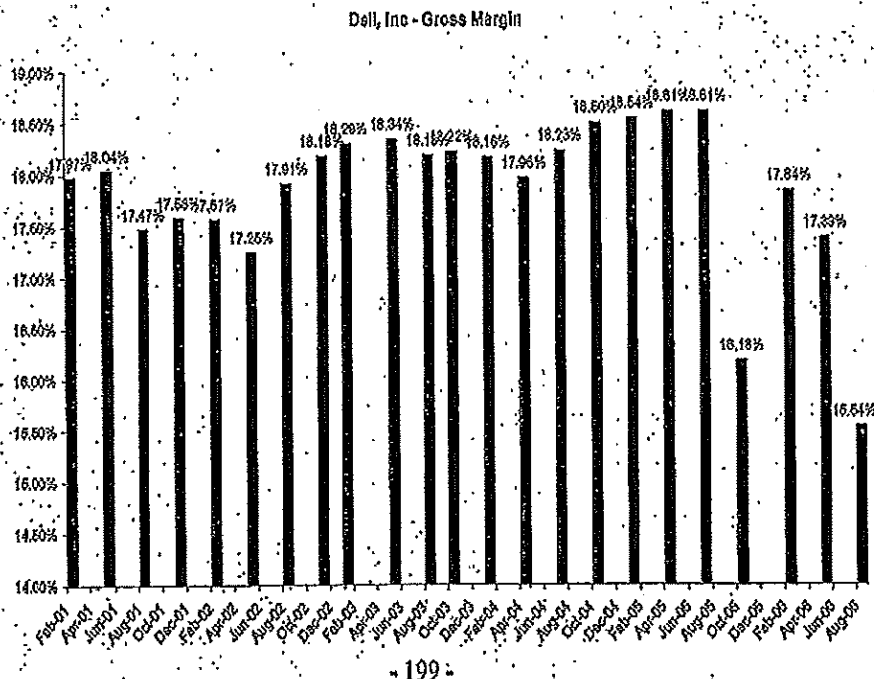
25. If, based on available information, it is probable that customers will make claims under warranties relating to goods or services that have been sold, the condition in paragraph 8(a) is met at the date of an enterprise's financial statements because it is probable that a liability has been incurred. Satisfaction of the condition in paragraph 8(b) will normally depend on the experience of an enterprise or other information.

245. In fact, the motherboards in the OptiPlex GX270 and GX280 business desktop computers had capacitors which bulged and failed and would cause the PCs not to boot. The system boards in question were manufactured from 4/03 to 3/04. At issue were faulty capacitors on motherboards that store power and regulate voltage. Defective capacitors found in the Dell OptiPlex workstations and PCs with the Intel D865GBF motherboard have been found to bulge, pop, leak and crust over, causing video failure and periodic system shutdowns. The solution to this problem was to replace the motherboard -- a time-consuming process. The capacitors are relatively inexpensive but replacing the whole motherboard on numerous PCs was very expensive. Thus, if there were any problems with the product, the likelihood of claims was high

and the cost of correcting the problem was significant – both factors that should have increased Dell's accruals for this contingency.

246. Dell knew long before the 3rdQ F05 that it had problems with the OptiPlex GX270 and GX280. In 11/04, Dell China confirmed problems with the GX280 PC. Computer repair shops noticed frequent "blue screens of death" and various programs that crashed on the systems in 1/05. By 2/05, Dell was replacing all the motherboards with no questions asked.

247. Belatedly, in the 3rdQ F05, Dell recorded a \$307 million charge to reflect the costs to service OptiPlex™ systems, including a vendor part that failed to perform to specification. This was a huge charge, reducing Dell's gross profit in the quarter ended 10/28/05 to 16.18%, from its reported rate in most quarters of the Class Period of 17.8% to 18.5%. Note the following chart which shows Dell's gross margin, including the OptiPlex write-off and the most recent quarter where gross margin fell to 15.54% due to the elimination of the rebates from Intel, described below, and due to Dell having to cut prices dramatically to make up for lost sales due to service and product problems:



248. Had Dell properly accrued for warranty expenses it knew it would incur for the OptiPlex™ problems in a timely fashion, its gross margin and earnings in the last part of 2004 and first half of 2005 would have been materially lower than the amounts Dell reported.

249. That Dell was understating its reserve for warranty costs is demonstrated by the relationship of actual cash warranty costs to the warranty reserve. In 1stQ F04, the warranty cost as a percentage of warranty reserve was about 30% (comparable to Hewlett-Packard and just above EMC). However, by end of F04 and early F05, the ratio increased to above 40% and has stayed there since. At the same time, Hewlett-Packard's and EMC's respective ratios have declined. This is an indication that Dell was under-reserving for warranty costs. These increasing costs also indicate deteriorating product quality. The decreasing reserve came in the face of Dell switching its basic warranty on consumer PCs from 90 days to one year in mid F05, which would increase the liability.

250. Dell was also required to recognize extended warranty revenue over the term of the warranty. FASB Technical Bulletin ("FTB") No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, states in part:

Like short-duration insurance contracts, extended warranty and product maintenance contracts provide coverage against the risk of certain specified claim costs for a specified period. Those claim costs may take the form of repair costs if the product requires repair or service costs if the customer requests that a covered service be performed on the product. Paragraph 13 of Statement 60 indicates that premiums from short-duration insurance contracts should be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. This Technical Bulletin concludes that revenue on extended warranty and product maintenance contracts also should be recognized in income evenly over the contract period except for those circumstances in which sufficient historical evidence indicates that costs of providing services under the contract are incurred in some pattern other than straight line.

FTB 90-1, ¶9.

251. Dell represented that it did so. In its F06 Form 10-K, Dell stated:

Revenue from extended warranty and service contracts, for which Dell is obligated to perform, is recorded as deferred revenue and subsequently recognized over the term of the contract or when the service is completed.

252. Because Dell combined the accounting for basic and extended warranties in one number, it obscured the under-accrual of warranty costs and the over-recognition of warranty income from the sale of extended warranties. Both manipulations caused Dell's income to be overstated.

Dell Failed to Make Required Disclosures About the Existence, Impact and Uncertainty of Intel Rebates

253. It has now been documented extensively that over the past several years, in an effort to maintain its market share, Intel has paid rebates to computer manufacturers on a retroactive basis. Note how *Fortune* explained the rebates:

Suppose XYZ computer maker needs 100 chips per quarter, and that during the last quarter it bought 90 from Intel and ten from AMD. Since AMD wants to grow, it might bid for 20 of XYZ's 100 units in the new quarter. . . .

Here's how Intel allegedly dashes AMD's hopes for gradual growth. It tells XYZ that its price per processor is, say, \$90, but that if XYZ ends up buying more than 80% of its processors from Intel that quarter, it will pay a rebate of \$10 per processor, resulting in an \$80 price. The rebate, however, applies not just to the processors that put XYZ over the 80% target, but to *every Intel processor XYZ purchases that quarter, back to the first one*. That offer knocks AMD out of the box. [AMD] [outside counsel [Charles] Diamond explains why: "Effectively, what Intel's saying is, If you don't buy those ten incremental units from AMD, we'll give you them for free." That's because 80 processors at \$90 each cost the same as 90 processors at \$80 each."

(Emphasis in original.)

254. As either the top seller of personal computers (or close to it at all times during the Class Period), Dell was a top recipient of Intel's rebates. These rebates were significant to Dell's reported financial results. Even much smaller computer makers received significant rebates, with Toshiba, for example, receiving \$100 million per year. Dell's rebates, given its size, were approximately \$1 billion per year. These rebates (internally called "e-CAP dollars") were the